United States Senate
Republican Policy Committee

Jon Kyl, Chairman
Lawrence Willcox, Staff Director
347 Russell Senate Office Building
Washington, DC 20510
202-224-2946
http://rpc.senate.gov

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Energy Taxes: Reducing Supply, Increasing Price

Executive Summary

- Proposals in the Senate-passed tax-reconciliation bill to single out major integrated oil and gas companies for punitive tax treatment, by imposing a one-time accounting revaluation of oil inventories and by limiting allowable foreign tax credits, would undermine competitiveness, jeopardize the employment of million of Americans, and hamper future job growth.

- The U.S. oil and gas industry is a critical component of the U.S. economy, contributing $139 billion to GDP in 2002, as well as providing 1.5 million jobs for Americans with a payroll of $39.29 billion.

- The U.S. oil and gas industry is highly capital-intensive industry, investing tens of billions of dollars each year in risky, long-range energy exploration and production projects. For example, the oil and gas extraction industry invests a higher percentage of its gross output in capital expenditures than any other major industry.

- The industry is already heavily taxed, facing an effective tax rate of 38.3 percent, while the average effective tax rate for the market as a whole is 32.3 percent.

- If enacted, these tax penalties would set a dangerous precedent of using the tax code, which is already unduly burdensome, to punish a subset of a single industry.

- The proposed tax penalties would substantially increase tax costs for U.S. oil and gas companies that compete for energy resources in the global marketplace.

- These tax penalties would increase the cost of capital expenditures by the industry, making such expenditures less likely.

- Since current investment is critical to future energy supply, these tax penalties would reduce future energy supplies and raise future energy prices.

- For all of these reasons, conferees should work to remove these onerous provisions from the final bill.

Introduction

When approaching energy issues, Congress should take care to avoid policies that inflict further harm on consumers. Numerous approaches to energy policy are available, including deregulation, tax cuts, subsidies, and mandates to reduce demand, among others. And while the relative merits of each approach are debatable, surely it is beyond debate that Congress should avoid hampering efforts to provide reliable supplies of energy at affordable prices.

Yet, that is exactly what some have sought to do. For example, some lawmakers seem intent on punishing energy companies for circumstances beyond their control. Last year, "windfall profits tax" amendments were offered in the Senate on the grounds that oil and gas industry profits were excessive and should be taxed away.[1] This policy would have pushed gasoline prices even higher, not only in the short-term, but also for the long-term. Fortunately, such ideas were rejected.

Nevertheless, the Senate-passed version of the tax-reconciliation bill contains two provisions that would, likewise, penalize the U.S. energy sector, reduce energy supplies, and raise energy prices.[2] These provisions are the one-time accounting revaluation of oil inventories, and a limitation on allowable foreign-tax credits. Before addressing these current tax proposals, this paper provides an overview of the oil and gas industry and its important contribution to the U.S. economy.

A Profile of U.S. Oil and Gas Industry

A Capital-Intensive Industry

The U.S. oil and gas industry is a critical component of the economy, providing energy resources for every sector. For example, the industry's direct value-added[3] contribution to Gross

[1]Three amendments – S.Amdt. 2635, S.Amdt. 2626, and S.Amdt. 2585 – to S. 2020 sought to establish a temporary windfall profits tax.

[2]The Senate passed the Tax Relief Act of 2005, S. 2020, on November 11, 2005, by a vote of 64 to 33.

[3]Value added is the contribution of each industry's labor and capital to the overall GDP of the United States. See, Bureau of Economic Analysis, *Annual Industry Reports*, December 15, 2005 – http://www.bea.gov/bea/pn/GDPbyInd_VA_NAICS.xls.

Domestic Product (GDP) in 2002 was $139 billion.[4] As employers, the industry provided nearly 1.5 million jobs for 2002 with a payroll of $39.29 billion.[5]

But this is only part of the story. Without oil and gas resources, many of the nation's important economic sectors would be a tiny fraction of their current size. For example, trucking, which employs nearly 1.5 million people, would virtually cease to exist without the products provided by the oil and gas industry.[6] The same holds true for manufacturing, agriculture, construction, and numerous other industries that employ many millions more.

Despite its importance to the U.S. economy, the industry came under attack last year after earning record profits – an attack that has resumed with the release of the results for the fourth quarter of 2005. The attacks became particularly acute when gasoline prices exceeded $3 per gallon following Hurricane Katrina, which scored a direct hit on Gulf Coast oil and gas operations.

These profits need to be put into proper perspective, however. Chart 1, on the following page, compares the oil and gas industry's third-quarter profits, in terms of earnings per dollar of sales, to other major U.S. industries. As can be seen, oil and gas profits were only slightly higher than the U.S. average, earning 8.2 cents for every dollar of sales, versus 6.8 cents industry-wide. Indeed, several U.S. industries earned much higher profits than did the oil and gas industry, including banking (18 cents per dollar of sales), consumer services (10.1 cents), software and services (9.9 cents), and telecommunications (9.1 cents).

In the second quarter of 2005, oil and gas industry profits (7.7 cents per dollar of sales) were below the industry average (7.9 cents). And for the previous five years, the oil and gas industry earned 5.8 cents of profit per dollar of sales compared to the U.S. industry average of 5.5 cents.[7] Most recently, U.S. oil and gas companies saw their 2005 fourth quarter profits rise again. Exxon Mobil earned 10.7 cents per dollar of sales, Chevron 7.7 cents, and ConocoPhillips 7.0 cents. But again, numerous companies from many industries earned higher profits, including

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[4]U.S. Census Bureau, *2002 Economic Census Reports*, 2004 – http://www.census.gov/econ/census02/index.html. This number includes jobs from various oil- and gas- related industries, including oil and gas extraction; natural gas liquid extraction; petroleum refining; pipeline transportation and construction; natural gas distribution; lubricant, petrochemicals and industrial gas manufacturing; petroleum and petroleum products wholesalers; and gasoline stations.

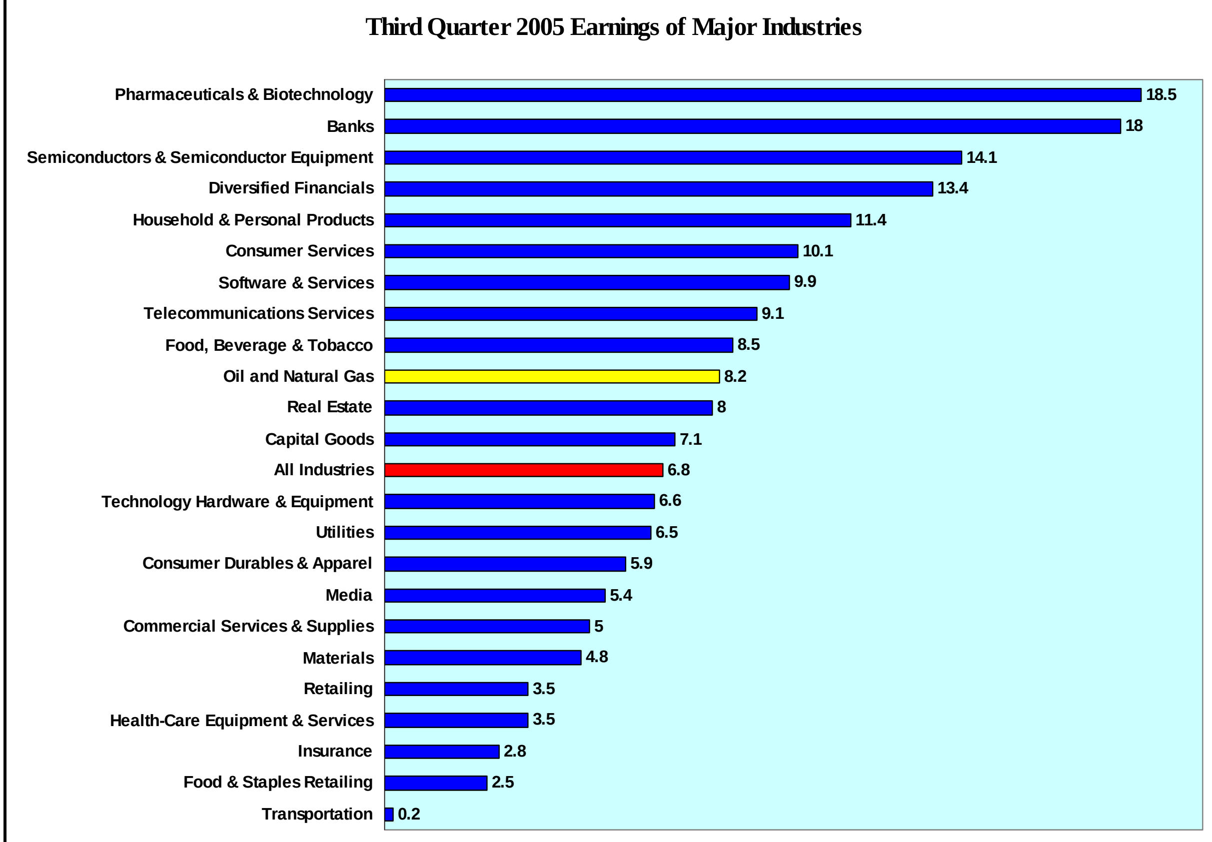
[5]U.S. Census Bureau, 2004. The Independent Petroleum Association of America (IPAA) has also compiled industry employment numbers using statistics from the U.S. Bureau of Labor Statistics and state agencies. They estimate that the industry employed 1.64 million people in 2004. See, IPAA, *The Oil & Gas Producing Industry in Your State*, July 2005.

[6]U.S. Census Bureau, 2004.

[7]Figures based on data from PricewaterhouseCoopers LLP, Standard & Poor's Compustat, and *Business Week's* "Corporate Scorecard" – http://api-ec.api.org/filelibrary/ACF1C3.pdf.

McDonalds (11.6 cents), AT&T (12.8 cents), Apple (22.7 cents), Bank of America (26.7 cents), and Yahoo (45.5 cents).[8]

Chart 1



Source: Based on company filings with the federal government as reported by the *Oil Daily* for oil and gas and by PricewaterhouseCoopers LLP from data compiled by Standard & Poor's Compustat for all other industries. Provided to the RPC by the American Petroleum Institute.

Moreover, the U.S. oil and gas industry is a highly capital-intensive industry, which invests billion of dollars per year in capital expenditures related to energy exploration, development, and infrastructure (the oil and gas extraction industry invested $41.6 billion in 2003 alone).[9] For example, in 2004:

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[8]Data calculated from company financial reports filed with the government. Provided to the RPC by the American Petroleum Institute. See, http://api-ec.api.org/filelibrary/EARNINGS%204q06_earningschart_land01_30_06.pdf.

[9]U.S. Census Bureau, *Annual Capital Expenditures: 2003*, May 2005 – http://www.census.gov/prod/2005pubs/ace-03.pdf

- Chevron reported net income of $13.33 billion, and reported $8.32 billion in capital expenditures. Over the five-year period from 2000 to 2004, Chevron spent more on capital expenditures ($46.38 billion) than it earned ($32.71 billion) .[10] Chevron has announced planned expenditures of $14.8 billion for 2006 to increase production and develop new energy sources.
- From 2000 to 2004, Exxon Mobil reported net income of $91.34 billion and capital expenditures of $67.86 billion.[11] Over the previous 10 years, ExxonMobil's capital expenditures exceeded net income.[12]
- ConocoPhillips (the two companies merged in 2002) reported total net income of $12.87 billion and capital expenditures of $15.67 billion during the period from 2003 to 2004.[13]

These investments involve considerable risk, given the high-dollar capital commitments required and the long periods of time needed to realize a return on these investments. Since current investment determines future supply, if companies do not invest now in exploration, development, and production, then 10 to 15 years down the road supply will fall further and further behind demand and prices will rise.

As chart 2 on the following page shows, the oil- and gas-extraction industry invests a larger share of its gross output than any of the other industries listed in the U.S. Census Bureau's report on capital expenditures.[14]

An Industry with a Heavy Tax Burden

When examining the merits of the current energy tax proposals contained in the pending tax-reconciliation bill, it is important to understand that the oil and gas industry is already heavily taxed. According to the Tax Foundation, the effective tax rate for major integrated oil and gas companies is 38.3 percent, while the average effective tax rate for the market as a whole is 32.3 percent.[15] The combined 2005 gross earnings of Exxon Mobil, Chevron, and ConoPhillips was $108.2 billion. During 2005, the three companies paid $44.3 billion in corporate income taxes, an increase of 49.2 percent over 2004. They also paid a combined

[10]Chevron, *2004 Supplement to the Annual Report*, 2005 – http://investor.chevron.com.

[11]ExxonMobil, *2004 Summary Annual Report*, *2005* – http://ir.exxonmobil.com.

[12]See, *Planting Profts*, an ad by ExxonMobil, http://www.exxonmobil.com/Corporate/Files/Corporate/OpEd_plantingprofits.pdf.

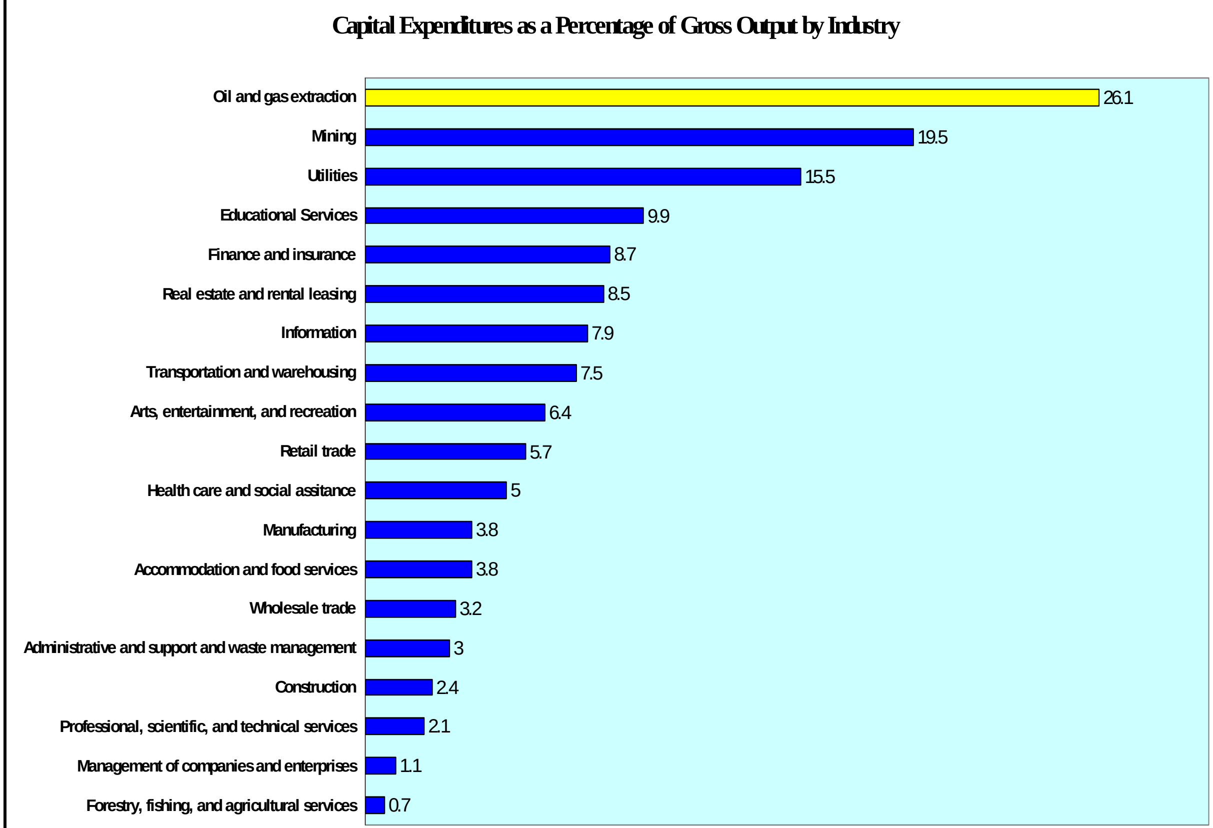
[13]ConocoPhillips, Inc., *2004 Annual Report, 2005* – http://www.conocophillips.com/investor/index.htm.

[14]For data on capital expenditures see U.S. Census Bureau, *Annual Capital Expenditures: 2003*, May 2005. For data on gross output by industry see Bureau of Economic Analysis, *Annual Industry Accounts*, December 15, 2005 – http://www.bea.gov/bea/dn2/home/annual_industry.htm.

[15]Jonathan Williams and Scott A. Hodge, "Large Oil Industry Tax Payments Undercut Case for 'Windfall Profits' Tax," *Tax Foundation*, January 31, 2006 – http://www.taxfoundation.org.

$114.5 billion in other taxes, including franchise, payroll, property, severance and excise taxes.[16] All totaled, that is hardly an insignificant burden.

Chart 2



Source: U.S. Census Bureau and Bureau of Economic Analysis.

Increased Energy Profits Means Higher Dividend Payments to Average Americans

Finally, it must be remembered that these companies are owned by millions of shareholders, not just through direct ownership of shares, but also through pensions, insurance

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[16]Jonathan Williams and Scott A. Hodge, January 31, 2006. To arrive at "net income," a company subtracts income taxes from gross earnings. The "other taxes" noted above, such as excise taxes, are in the cost and expenses category on the income statement, so they also come out of gross income. However, they are often added as revenues on income statements and then subtracted as costs, thereby creating a netting-out effect. This gives the mistaken impression that total taxes are higher than gross income. Regardless, the oil companies' tax bill is exorbitant.

funds, and mutual funds. Dividend payment to shareholders make up a significant portion of company expenditures. From 2000 to 2004, Exxon Mobil paid out $32.01 billion in dividend payments and Chevron paid $14.63 billion. ConocoPhillips paid a total of $15.67 billion to its shareholders in 2003 and 2004. In addition, it has been reported that in 2005, the six largest oil companies will disperse 34 percent of their cash flow, or $31 billion, in dividends to shareholders.[17] With 57 percent of American age 65 and older reporting dividend income, according to the most recent data, those large oil company dividends will likely enhance the retirement income of many of the nation's senior citizens.[18]

Tax Penalties in the Tax Reconciliation Bill and their Economic Effects

Despite the significant tax burden already borne by U.S. oil and gas companies, the Senate's version of the tax-reconciliation bill includes two provisions that dramatically increase that burden. This flawed tax policy has far-reaching implications.

LIFO Penalty on Oil Companies

The first energy-related tax provision in the Senate bill relates to accounting methods used by large integrated U.S. oil and gas companies. In general, the tax code requires that taxpayers maintain accurate records to substantiate the income reported and deductions claimed to derive their taxable income.[19] In addition, businesses that manufacture and sell products must maintain inventories in order to match the cost of the product with the income it generates.[20] While the tax code permits several accounting methods with respect to inventories, one that is widely applied in most industries is the so-called "last in, first out" or "LIFO" method.[21]

Under the LIFO system, which has been permitted since the 1930s, an oil company is generally allowed to match the income from the sale of a barrel of oil against the cost of the most recently acquired barrel. In other words, the last barrel purchased is treated as the first barrel sold. This accounting method is based on the theory that each barrel of oil is basically identical, and the most recently purchased item best reflects the current cost that should be associated with the price received upon its sale.

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[17]George Will op-ed, "Windfall for the Dimwitted," *Washington Post*, December 4, 2005.

[18]Data supplied by the Internal Revenue Service, Statistics of Income Division, based on tax year 2003 income-tax returns.

[19]Section 446 of the Internal Revenue Code of 1986, as amended (IRC).

[20]IRC Section 471.

[21]IRC Section 472(c).

If the company acquires more oil than it sells in a particular year, it accounts for the excess as an inventory "layer" for that year.[22] Each inventory layer's value is generally equal to the average cost of the inventory within the layer. In years when the company sells more than it acquires, it uses up prior inventory layers. The costs of the currently acquired inventory and each historic inventory layer are combined as the company's cost of goods sold, which the company subtracts from gross income on the sale of the oil to yield its taxable income for the year.

The provision in the Senate tax-reconciliation bill would arbitrarily require large integrated U.S. oil and gas companies to revalue their historic LIFO inventory layers. Such companies are defined as producers of crude oil that have (1) integrated retail or refining operations; (2) average daily worldwide production of at least 500,000 barrels of crude oil for the relevant tax year; and (3) gross receipts in excess of $1 billion for the tax year.[23] Specifically, the provision would require affected companies to add $18.75 to the cost per barrel in each LIFO layer.[24] Chart 3 illustrates the effects of this provision for a hypothetical large integrated U.S. oil company.

Chart 3

LIFO Penalty on Large Integrated U.S. Oil & Gas Companies

Year	Barrels in Inventory (millions)	Original Cost per Barrel	Value of Inventory Layer (million)	Mandated Adjustment per Barrel	Revalued Inventory Layer (million)
2004	20	$35	$700	$18.75	$1,075
2000	30	25	750	18.75	1,313
1985	100	18	1,800	18.75	3,675
1955	50	5	250	18.75	1,188
Total	200		$3,500		$7,251

If the LIFO provision were enacted, the hypothetical company's total inventory value would have to be adjusted from $3.5 billion to $7.25 billion – a $3.75 billion increase. And, the

[22]Joint Committee on Taxation (JCT), "Description of the Chairman's Modification to the Provisions of the 'Tax Relief Act of 2005,'" JCX-77-05, November 14, 2005, p. 109 – http://www.house.gov/jct/x-77-05.pdf.

[23]S. 2020, Section 561(d).

[24]S. 2020, Section 561. See also JCT, p. 110.

same provision requires the company to reduce its cost of goods sold by an equal amount. Accordingly, the hypothetical company's taxable income would increase by $3.75 billion, even though the company realized *no added economic benefit*.

It is difficult to justify this arbitrary change in the long-standing accounting rules. There has been no showing that the LIFO method is no longer sound in general, and if it were, sensible tax policy would require that the LIFO method be changed or eliminated for *all* taxpayers. Moreover, this change cannot be justified based on its inappropriateness for a particular segment of the economy since it does not apply to all taxpayers in the petroleum industry, but only to large integrated oil companies. Finally, this provision is not a permanent change (even for the limited number of affected taxpayers) – it applies only to tax years ending in 2005.

In short, this provision is nothing more than a substantial penalty imposed on a small number of companies – taxpayers that are perceived to have committed an offense because of the magnitude of their profits. More broadly, if enacted it would set a dangerous precedent of using the tax code, which is already unduly burdensome, to punish taxpayers rather than merely to raise revenues.

Moreover, the provision would have adverse economic consequences. The primary effect of the LIFO tax penalty would be the reduction of the investment capital needed to ensure the long-term availability of energy supplies. According to the Joint Committee on Taxation, the tax penalty on the few affected companies would be nearly $5 billion.[25] That amount would no longer be available to invest in exploration, development, or production of oil and natural gas. Nor would it be available to invest in important infrastructure improvements or in refining capacity.

This is similar to what happened when Congress enacted a Windfall Profits Tax (WPT) in 1980. According to the Congressional Research Service (CRS), the WPT reduced domestic oil production from between 3 percent and 6 percent over its lifetime (incidentally, it also increased oil imports from between 8 percent and 16 percent).[26] Likewise, a tax increase through a revaluation of LIFO inventories would reduce current investment in oil production, which would reduce future supply and raise future prices.

Another similarity to the WPT is the harm this LIFO provision could do to shareholders and other savers who hold energy company stocks in their retirement accounts, pension funds, and mutual funds, including many seniors who live on fixed incomes. A recent study found that the windfall profits tax offered and rejected last year would have cost shareholders between

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[25]Joint Committee on Taxation, *Estimated Revenue Effects of S. 2020*, November 16, 2005 – http://www.house.gov/jct/x-80-05.pdf.

[26]Congressional Research Service, *The Windfall Profit Tax on Crude Oil: Overview of the Issues*, September 12, 1990.

$21.3 billion and $121.9 billion per year.[27] Although on a smaller scale, the LIFO penalty is also likely to prove costly to American savers and retirees. And, if shareholder dividends and/or capital gains decline as a result of the LIFO provision, income taxes on those lost dividends and capital gains will never be paid. Thus, the government, too, is likely to be adversely affected by this ill-advised change in tax policy.

Foreign-Tax Credit Penalty on Oil Companies

The second energy-related provision in the Senate bill concerns special rules designed to avoid double taxation of U.S. companies operating abroad. In general, the United States taxes all of the worldwide income of its citizens, including all domestic and foreign earnings of U.S. companies.[28] The United States also fully taxes income earned overseas by foreign subsidiaries of U.S. multinational companies. In contrast, many foreign countries (notably France and Germany) tax their companies on a territorial basis. As a result, these countries only tax income earned within their borders and do not impose tax on the earnings of their multinational companies' foreign subsidiaries that are located outside of their national borders.

A foreign company taxed under a territorial-based tax system has a significant advantage over a U.S. multinational. For example, a U.S. company with a Nigerian subsidiary would pay U.S. tax and Nigerian tax on the subsidiary's income. A French company with a Nigerian subsidiary will pay only the Nigerian tax – France collects no tax because the income was earned abroad. Hence, the U.S. company in Nigeria would face a much higher tax burden than its French competitor.

One of the principal ways that the current U.S. tax law addresses this problem is through the "foreign tax credit." Since 1917, the United States has allowed a U.S. company that repatriates the income of its foreign subsidiary to reduce its U.S. taxes by the amount of any foreign taxes paid on that income.[29] That reduction is accomplished through a foreign tax credit, which helps prevent the U.S. multinational from paying both U.S. and foreign taxes on the same income.[30] As a result, the foreign-tax credit reduces, but does not fully eliminate, the tax disadvantage that U.S. multinationals face in the international marketplace.

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[27]Robert J. Shapiro and Nam D. Pham, "The Economic Impact of a Windfall Profits Tax For Savers and Shareholders," *Sonecon*, November 2005.

[28]See *Cook v. Tait*, 265 U.S. 47 (1924).

[29]IRC Section 901.

[30]The foreign tax credit, however, may not exceed the maximum U.S. corporate-tax rate of 35 percent. IRC Section 904(a). If the foreign tax rate is higher, the foreign tax credit stops at 35 percent, and the taxpayer pays double taxes to the extent of the excess. If the foreign tax rate is lower (e.g., 20 percent), then the foreign tax credit will also be limited to that lower rate and additional U.S. taxes will be owed up to the full 35 percent U.S. rate.

The provision in the Senate tax-reconciliation bill would deny the foreign-tax credit to a large integrated U.S. oil and gas company if it pays taxes in a foreign country, but that country does not have a generally applicable income tax – one that applies to all trades or businesses.[31] For example, Saudi Arabia, Qatar, and Kuwait impose an income tax on non-domestic companies doing business in their countries, but there is no generally applicable income tax on all businesses.[32]

Accordingly, the provision in the Senate bill, like the LIFO provision, is nothing more than a penalty imposed through the tax code on a very small number of U.S. multinational corporations. Large integrated oil and gas companies would be subject to the limitation on their foreign-tax credit, while other businesses in the automobile, consumer products, and technology industries, for example, would continue to receive their full foreign-tax credit. Moreover, it is not simply a penalty on the oil and gas industry – only large integrated companies are punished while other U.S. oil and gas companies continue to benefit from the foreign-tax credit.

Aside from its disparate tax treatment and fundamental unfairness, the foreign-tax credit limitation also has the potential to create significant adverse economic consequences. As noted above, U.S. companies face a worldwide tax while their foreign competitors do not. The foreign-tax credit was designed to minimize the competitive disadvantage that U.S. companies face in the global marketplace. By limiting the availability of that equalizing mechanism, the Senate provision would increase the tax rate that large integrated U.S. oil and gas companies must bear. And, the same can be said of the LIFO revaluation, although as a result of an arbitrary change in long-standing, widely applicable accounting rules.

The result of both provisions would be less capital for investment in exploration and development, and these changes would create a significant competitive disadvantage in relation to foreign oil and gas companies competing for limited opportunities – in effect, *outsourcing* oil and gas production to foreign companies. Moreover, the companies affected by this provision

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[31] S. 2020, Section 570. Since 1983, U.S. oil and gas companies have been subject to limitations on the use of foreign-tax credits with respect to taxes paid in countries with no generally applicable income tax. See Treasury Regulation Section 1.907-2A. These regulations were generally designed to prevent abuse of the foreign-tax credit by U.S. taxpayers that pay both income taxes and other payments, such as royalties, to foreign governments with respect to their oil production activities (so-called "dual capacity taxpayers"). Also, the dual capacity taxpayer rules were designed to prevent developing countries from manipulating their tax and royalty policies to increase revenues from foreign companies, without affecting the companies' economic incentives, at the expense of the U.S. tax base. The provision in the Senate tax-reconciliation bill potentially eviscerates those long-standing regulations. See, J.D. Foster, "The President's Paradoxical Reforms for U.S. Companies' Foreign Oil and Gas Income," *Tax Foundation*, June 1997.

[32] United States Trade Representative, "2005 National Trade Estimate Report on Foreign Trade Barriers,"March 2005 – http://www.ustr.gov/assets/Document_Library/Reports_Publications/2005/2005_NTE_Report/asset_upload_file383_7446.pdf . These countries generally impose on local residents a religious tax that is established in a manner consistent with Islamic law.

are significant employers of U.S. workers, both domestically and abroad. The jobs these employers provide could be jeopardized if their ability to invest and compete globally is unnecessarily constrained.

In the end, if the foreign-tax-credit and LIFO provision were to be enacted, those disadvantages would likely result in the United States not only being more reliant on foreign oil and gas than it already is, but also heavily dependent on *foreign oil and gas companies* to supply the United States's energy needs. Clearly, that result would not be in the best interest of the nation's economic well being or its national security.

Conclusion

At a time when rising energy prices are straining American consumers, it is essential that the U.S. Congress avoid actions that would cause this trend to persist or even accelerate. Yet, two tax penalties within the Senate's tax-reconciliation bill would do just that. They single out a narrow segment of the U.S. oil and gas industry – the large integrated companies – for punitive tax treatment, thereby making it more difficult for these U.S. energy companies to produce additional energy supplies. Ultimately, this will harm consumers who will face even higher energy costs in the future. To avoid that result, these provisions should simply be removed in conference.